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No. 96-342

In the Supreme Court of the United States

OCTOBER TERM, 1996

UNITED STATES OF AMERICA, PETITIONER

v.

WABASH VALLEY POWER ASSOCIATION, INC.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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In opposing our petition, Wabash does not rely upon the language of the statute, its history, or the decisions of this Court. Rather, Wabash suggests that, because the court of appeals relied upon the "unique" factual circumstances in the case, this Court should deny review. Specifically, Wabash asserts that (1) the court of appeals did not create an "exception" to the absolute priority rule (Br. in Opp. 11-20), (2) the courts below properly found that the plan of reorganization maximized value to creditors (*id.* at 20-25), and (3) the Bankruptcy Code favors a policy of rehabilitation of debtors over creditors' rights to receive satisfaction of debts (*id.* at 26-28). Those arguments are unpersuasive.

1. Nowhere in its brief does Wabash quote the language of the absolute priority rule, long recognized as a "fixed principle" of reorganization law. *Northern Pac. Ry.* v. *Boyd*, 228 U.S. 482, 507 (1913). As we explain in our petition (Pet. 10-11), that rule, as codified, provides that a plan of reorganization can be confirmed as "fair and equitable" over the objection of a class of unpaid creditors *only* if

> the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.

11 U.S.C. 1129(b)(2)(B)(ii). By constructively adding the word "equity" before the word "interest" in the statutory language, the court of appeals (Pet. App. 28a-30a) created an exception for entities, such as Wabash, that are organized so that the economic benefits they derive do not accrue in the form of "profits." Wabash incorrectly asserts that this construction of the statutory language by the court of appeals was "unexceptional" (Br. in Opp. 20) and that its decision is correct (*id.* at 12-13).

a. Notwithstanding the factual recitals by Wabash —most of which do not bear on either whether this Court should grant certiorari or how it should decide the narrowly framed issue on the merits—Wabash provides no support for the court of appeals' conclusion that the term "interest" in the statute is limited to "equity interest." See Br. in Opp. 12-13. As we explain in our petition (Pet. 16-17 & nn.17-18), nothing in that language, the legislative history of the Bankruptcy Code, or this Court's decisions provides a basis for limiting the term in this manner to exclude application of the absolute priority rule to entities

that are not strictly "profit"-making enterprises. Indeed, in other contexts, this Court has read the term "interest" broadly. See *Russello* v. *United States*, 464 U.S. 16, 21 (1983) ("the term 'interest' comprehends *all forms* of real and personal property, including profits and proceeds") (emphasis added). The court of appeals here had no authority to rewrite the statutory language simply because it "deem[ed] [the Code's] effects susceptible of improvement." *Badaracco* v. *Commissioner of Internal Revenue*, 464 U.S. 386, 398 (1984), citing *TVA* v. *Hill*, 437 U.S. 153, 194-195 (1978).

Contrary to Wabash's claim, the decision of the court of appeals in this case is not limited to "Wabash Valley's idiosyncratic factual and legal" circumstances. Br. in Opp. 25. Rather, the decision below is plainly predicated upon a holding that exempts *all* not-for-profit cooperative entities from the absolute priority rule. While the court made passing reference to "Wabash's cooperative structure" in discussing whether continued REMC control of Wabash violates the rule (Pet. App. 27a), its analysis is based on the nature of cooperatives generally. See *id.* at 26a-30a. As the court stated, "[c]ooperatives are designed explicitly to allow customers to receive the benefits, in the form of lower prices, which might ordinarily accrue to the owners of equity" and that "potential for lower prices is simply not an interest cognizable in bankruptcy." *Id.* at 28a. That reasoning clearly applies to *any* form of cooperative. By creating a general exception for cooperatives, the court's holding excepts from the absolute priority rule a host of Chapter 11-eligible debtors, from large rural utilities to cooperatives and not-for-profit associations in all sectors of business. Pet. 20-21 & n.19.

b. Wabash incorrectly asserts that the absolute priority rule is inapplicable here because, as a cooperative, neither it nor its members can ever "profit" in a conventional sense of receiving a return on investment or a right to share in assets upon dissolution. See, *e.g.*, Br. in Opp. 15-16. Although Wabash does not sell electricity at a "profit," its members benefit economically by Wabash's ability to purchase electricity at a reduced cost. Wabash's member-REMCs, through control of assets, share in the economic benefit of "paying lower prices for power." *Id.* at 16. Such a result violates the proscription of the absolute priority rule against a debtor retaining an "interest" in "property" when a senior creditor remains substantially unpaid. 11 U.S.C. 1129(b)(2)(B)(ii).

Moreover, even if there were a distinction between the economic benefit from selling at a profit and buying at a reduced cost, the Wabash Plan vests in the REMCs the potential for future profits through their exclusive control over Wabash's assets. Wabash's claim (Br. in Opp. 18-19) that REMC control may be distinguished here because the REMCs currently lack any incentive to restructure Wabash on a for-profit basis is unconvincing. As we have shown (Pet. 19), there is presently no *legal* impediment to Wabash transforming itself into a profit-making entity after its debt to REA is substantially discharged under its plan of reorganization, a situation that would leave the REMCs in exactly the same position as equity holders of a for-profit entity. For precisely this reason, this Court has never recognized an exception to the absolute priority rule for cooperative enterprises, but instead has upheld the absolute priority rule as a "fixed principle" for all forms of debtors. See, *e.g.*,

Northern Pac. Ry., 228 U.S. at 507; *Case* v. *Los Angeles Lumber Prods. Co.*, 308 U.S. 106, 116 (1939); see also *Norwest Bank Worthington* v. *Ahlers*, 485 U.S. 197, 202 (1988). The economic benefit accruing to the REMCs from their control of Wabash's assets properly falls within the term "interest" under the Code and, contrary to the decision below (Pet. App. 28a), is properly cognizable in bankruptcy.[1]

For these same reasons, the decision below directly conflicts with *Ahlers*, 485 U.S. at 207-209, and *Unruh* v. *Rushville State Bank*, 987 F.2d 1506, 1509 (10th Cir. 1993), which hold that such retained control violates the absolute priority rule. As we explain in our

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[1] Wabash also errs in arguing that the REMCs retained control through Wabash's assumption of the supply contracts rather than "on account of" a claim or interest properly subordinate to REA's claim. Br. in Opp. 13. First, the distinction is a false one. The factual predicate for Wabash's contention is a legal opinion that essentially incorporates into the supply contracts the REMCs' control of Wabash "on account of" their position as cooperative members. See Pet. App. 89a-90a, citing C/V Tr. 502, 513-21; see also Pet. App. 134a-135a. Thus, there is no distinction, for purposes of the absolute priority rule, between control "on account of" the requirements of the REMCs' supply contracts and control "on account of" the REMCs' membership interests. They are one and the same.

Second, even if the REMCs retained some contractual "right" to control Wabash after confirmation of the plan that is wholly divorced from their membership interests, such an easy evasion of the absolute priority rule would render the rule meaningless. The protection afforded creditors under the rule would be illusory if insiders could retain control post-confirmation by the simple addition of a contractual provision permitting such control. "The shareholders of *any* corporate debtor might be able to evade the absolute priority rule under [such] reasoning." *Ahlers*, 485 U.S. at 210 n.8 (emphasis added).

petition (Pet. 13 & n.13), the decision also directly conflicts with *Ahlers*' determination that no exceptions to the rule, except for possibly the "new value" exception (see Pet. 8 & n.6), survived enactment of the Bankruptcy Code in 1978. *Ahlers*, 485 U.S. at 205-206. Certiorari is warranted to resolve those conflicts.[2]

2. Wabash further relies upon fact-findings made by the courts below to argue that REA can derive no greater benefit than what is provided in the Wabash Plan because the liquidation value is less than what REA would receive under the Plan. Br. in Opp. 17-18, 20-21. That contention is both incorrect and irrelevant.

a. Notwithstanding the lower courts' fact-findings, we do not agree that liquidation is the only alternative available. Rather, Wabash could raise its rates through principles of non-traditional rate-making, which include seeking relief from regulators to raise rates for special exigent circumstances such as financial difficulty. See generally L. Gilbert, J. Olson & L. Lockett, *Prospects for Foundering Utilities: Bankruptcy, Utility Regulation and Public Policy*, 90 Com. L.J. 150, 159 (1985).[3] Indeed, in both Indiana

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[2] The only distinction Wabash can offer (Br. in Opp. 14-15) is that *Ahlers* and *Unruh* involved for-profit debtors, but that argument is foreclosed by the plain language of Section 1129(b)(2)(B)(ii), which contains no such distinction.

[3] As the appendices to the Brief in Opposition make clear, when REA "instructed Wabash to file for rate increases sufficient to assure repayment[,] Wabash complied with transparent insincerity, making it clear to the state regulators that it would be delighted if they said no." Br. in Opp. App. B5. Under the Wabash Plan, Wabash has a clear economic incentive *not* to seek an increase in rates, because its members enjoy access to low-

and Michigan (which regulates Wabash's largest member, Fruit Belt Rural Electric Cooperative), investor-owned utilities have successfully pursued non-traditional rate relief to avoid financial problems traceable to nuclear plants. See, *e.g.*, *In re Public Serv. Co. of Indiana*, 72 Pub. Util. Rep. 4th (PUR) 660 (Ind. P.S.C. Mar. 7, 1986); *In re Consumers Power Co.*, 66 Pub. Util. Rep. 4th (PUR) 1 (Mich. P.S.C. Mar. 29, 1985).[4] Wabash and its members have consistently opposed raising rates to enable it to discharge its obligations to REA. Br. in Opp. App. A17, B5. So long as the REMCs maintain control over Wabash, they are able to oppose efforts to increase rates—and thus continue to enjoy all of the economic benefits of

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cost electricity *and* avoid repaying a substantial portion of the REA debt. *Id.* at A17, B10.

[4] At least five other state commissions have granted rate relief where traditional rules governing rate-making would otherwise preclude an increase in rates and thus adversely affect bankruptcy proceedings. In one situation, the rate relief was ordered to overcome an impediment to a bankruptcy court-approved reorganization plan. See, *e.g.*, *In re Eastern Maine Elec. Coop.*, 141 Pub. Util. Rep. 4th (PUR) 456 (Me. P.U.C. Mar. 24, 1993); *In re New Hampshire Elec. Coop.*, No. DR 92-009, 1992 WL 503262 (N.H.P.U.C. Oct. 5, 1992); *In re Washington-St. Tammany Elec. Coop.*, 128 Pub. Util. Rep. 4th (PUR) 72 (La. P.S.C. July 20, 1990); *In re Northeast Utils./Public Serv. Co. of New Hampshire*, 114 Pub. Util. Rep. 4th (PUR) 385 (N.H.P.U.C. July 20, 1990), aff'd *sub nom. In re Richards*, 590 A.2d 586 (N.H.), cert. denied, 502 U.S 899 (1991). Rate relief has also been ordered to avoid driving the regulated entity into bankruptcy. See, *e.g.*, *In re Long Island Lighting Co.*, 100 Pub. Util. Rep. 4th (PUR) 237 (N.Y.P.S.C. Mar. 8, 1989); see also *In re Wolf Creek Nuclear Generating Facility*, 70 Pub. Util. Rep. 4th (PUR) 475 (Ks. S.C.C. Sept. 27, 1985) (bankruptcy would warrant consideration of additional rate increase).

cooperative membership and low-cost electricity—without enhancing Wabash's ability to repay its debt to REA. Seen in this light, the court of appeals' conclusion that "control" by the debtor is not an "interest" cognizable under the absolute priority rule creates just the anomalous result this Court has consistently rejected—that a debtor could continue to reap benefits at the expense of unpaid creditors.[5]

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[5] Contrary to Wabash's suggestion, the outcome of this case was not determined by the prior litigation between the parties noted in our petition (Pet. 4 & n.3). In *National Rural Utilities Cooperative Finance Corp.* v. *Public Service Commission of Indiana*, 552 N.E.2d 23 (1990) (*reprinted at* Br. in Opp. App. A1-A17), the Supreme Court of Indiana affirmed the denial of a rate increase to Wabash on the theory that the Marble Hill project was not "used or useful" in the production of electricity and, therefore, its construction cost could not be included in Wabash's rate base. Br. in Opp. App. A9. In *Wabash Valley Power Association* v. *REA*, 903 F.2d 445 (1990) (*reprinted at* Br. in Opp. App. B1-B25), and *Wabash Valley Power Association* v. *REA*, 988 F.2d 1480 (1993) (*reprinted at* Br. in Opp. App. C1-C30), the Seventh Circuit rejected two attempts by REA to mandate a rate increase for Wabash by means of federal preemption. In rejecting REA's initial attempt to preempt Wabash's rates on the government's first appeal, however, Judge Easterbrook's panel opinion did conclude that the "federal taxpayers have been taken to the cleaners" in this case (Br. in Opp. App. B24), and that Indiana was trying to transfer "to the federal government and to other investors (most from out of state) the cost of its adventure in nuclear power" (*id.* at B25). Principles of preemption, however, prevented REA from receiving the rate increase it sought. *Ibid.* None of those decisions either presented or foreclosed the issue raised in this case: whether the absolute priority rule is inapplicable to cooperatives and permits the REMCs to retain control of Wabash, despite the failure of the Wabash Plan to pay the government in full. Of course, the absence of an issue worthy of this Court's plenary review in prior stages of the litigation is

And even if it were incontestable that REA is "better off" under the Wabash Plan, that finding is neither relevant nor sufficient to avoid application of the absolute priority rule. As this Court stated in *Ahlers*, the determination whether creditors are "better off" if a plan "fails to provide [creditors] adequate protection or fails to honor the absolute priority rule" is "for the creditors to make in the manner specified by the Code," not the courts. 485 U.S. at 207. Thus, while the statute requires the bankruptcy court to find before confirmation that *every* Chapter 11 plan pays objecting creditors as much as or more than they would receive in liquidation, 11 U.S.C. 1129(a)(7), that finding may not substitute for compliance with the absolute priority rule, which ensures that the plan will not enable the debtor to retain an "interest" in "property" while a secured creditor remains substantially unpaid. See, *e.g.*, *In re Perez*, 30 F.3d 1209, 1213 n.3 (9th Cir. 1994). Although the court below conceded as much, Pet. App. 32a, it nonetheless failed to adhere to that statutory requirement.

3. Wabash is mistaken in asserting that the Bankruptcy Code does not permit the government to file a dispositive objection to its plan. Br. in Opp. 26-28. While the Code certainly permits a court to confirm a plan of reorganization over the objections of creditors, adherence to the absolute priority rule is a precondition of the plan being deemed "fair and equitable," and thus appropriate for confirmation. 11 U.S.C. 1129(b)(2)(B). This Court stated in *Ahlers* that a court's authority "must and can only be exer-

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no impediment to this Court reviewing the issue presented in the petition.

cised within the confines of the Bankruptcy Code," and "courts applying the [Bankruptcy] Code must effectuate [a creditor's] decision" on application of the absolute priority rule. 485 U.S. at 206-207. "[R]elief from [a debtor's] woes cannot come from a misconstruction of the applicable bankruptcy laws." *Id.* at 209. The court's failure to construe its statutory obligation properly created an easily replicable exception to the absolute priority rule that warrants this Court's review.

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For the reasons stated above and in the petition for a writ of certiorari, the petition should be granted.

Respectfully submitted.

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Acting Solicitor General

OCTOBER 1996